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BULLISH BANK, BEARISH INVESTORS

By Gordon Pape, Editor and Publisher

As everyone knows by now, the Bank of Canada raised its key interest rate again last week. It was the second quarter-point hike this summer and it came with some encouraging words about our economy.

"Recent economic data have been stronger than expected, supporting the Bank's view that growth in Canada is becoming more broadly-based and self-sustaining," the accompanying statement said. Although some moderation in growth is expected in the second half of the year, the overall level of GDP is higher than originally expected.

And it's not just Canada. "The global economic expansion is becoming more synchronous, as anticipated in July, with stronger-than-expected indicators of growth, including higher industrial commodity prices."

The only warning the Bank had for us was concern about "significant geopolitical risks" that could affect trade and fiscal policies. Although it was not mentioned, the NAFTA negotiations would be front and centre in that regard.

Overall, however, the statement was remarkably bullish, especially in view of the guarded approach the Bank had been taking prior to its July rate hike.

Investors don't seem to share this enthusiasm, however. Look at these year-to-date returns from some of the world's major stock indexes as of the close of trading on Sept. 8.

Hong Kong +25.8%
Brazil +21.9%
India +21.4%
Nasdaq +18.2%
Dow Jones Industrials +10.3%
S&P 500 +9.9%
S&P/TSX Composite -2.0%

Our S&P/TSX Composite is the only major market in the world that was in the red at that point.

The major U.S. indexes – Nasdaq, the Dow, and the S&P 500 – are in or close to double-digit territory. Hong Kong and India are shooting out the lights.

Continued on page 2…

I N T H I S I S S U E

Bullish Bank, bearish investors 1
Trump dominates Toronto Money Show 3
Expect more interest rate hikes 3
Gavin Graham's bank updates 4
Gordon Pape updates Wells Fargo, TransCanada, Amazon.com 6

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Bullish, bearish – continued from page 1…

Meanwhile, we are at the back of the pack despite the fact we are turning in the strongest economic performance of any country in the G7.

What gives? For the answer, let's look at the composition of the TSX.

Financials: 34.5%
Energy: 19.6%
Materials: 12.3%
Industrials: 9.5%
Consumer discretionary: 5.3%
Telecommunications: 5.0%
Consumer staples: 3.7%
Information technology: 3.3%
Utilities: 3.3%
Real estate: 3.0%
Health care: 0.6%

As you can see, the TSX is heavily overbalanced towards financials – more than one-third of the total weighting. And despite great results from the banks, that sector has been limping along this year, with a loss to of 1.4%.

The energy sector, which makes up the second largest component of our index, is in even worse shape. In fact, it's in bear market territory with a year-to-date loss of 22.9%.

That's 54% of the TSX that is in negative territory for the year. No wonder we can't gain any traction.

The big gainers in New York this year have been in sectors in which we barely have any presence at all. For example, the Dow Jones Internet Commerce Index is ahead 32.4% year to date. As a country, we aren't there at all. The S&P Health Care sector is up 18.9%. Our largest health care company is Valeant Pharmaceuticals, whose stock has been pummeled. And on it goes.

The bottom line is that our stock market strengths are in the wrong areas for current conditions. The only sector that has really done well is gold.

What does this mean for Canadian stocks going forward? Unfortunately, there is not much to be positive about, despite the strength of the economy. There are a lot of headwinds out there. Here are some of them.

Strong growth won't last. The Bank of Canada has warned that the growth rate will moderate in the second half and most economists agree. Slowing growth in the third and fourth quarters is not going to encourage investors.

Energy sector still in trouble. There is nothing to suggest that the energy sector will stage a sudden, miraculous recovery. There is still a world glut of oil, despite the OPEC cutbacks. Plus, U.S. shale oil producers have figured out how to pump more for less cost. That will continue to put pressure on Canadian prices.

Housing market slowing. New measures taken by Ottawa and the governments of B.C. and Ontario have dampened the overheated markets in Toronto and Vancouver. We've already seen a drop in prices and sales and the latest interest rate hike won't help.

NAFTA negotiations create uncertainty. Donald trump's repeated threats to tear up NAFTA need to be taken seriously. This is a president who is in serious trouble and is desperately searching for some raw meat to give to his base. If he follows through, it would be a real blow to Canada and our economy.

Higher interest rates will push loonie higher. The Bank of Canada may not be done with rate hikes while in the meantime it looks like the U.S. Federal Reserve Board will hold the line. That will be bad news for exporters because the likely result is a higher Canadian dollar.

Overvaluation in New York will trigger a sell-off. I continue to be concerned about the overvaluation in New York. The price/earnings ratio of the S&P 500 is way above its long-term mean of 15.7 and higher than just before the crash of 1929. I would be amazed if we don't see a correction of 10% to 15% on Wall Street in the next few months. If that happens, the TSX will follow New York's lead.

So what should you be doing? Three things.

Diversify internationally. Don't overweight the Canadian market. Have a decent proportion of your equity assets in international markets.

Review your asset mix. Bonds are not going to fare well in a period of rising interest rates but history shows us that portfolios with a strong fixed-income component fare much better when stocks retreat. If you are risk-conscious, you may want to increase your bond weighting accordingly.

Add some gold. Gold prices have been moving higher in response to international concerns over North Korea, trade relations, and the Trump administration. It never hurts to own at least one gold stock. I like (and own) Franco-Nevada (TSX, NYSE: FNV), which has been on our Recommended List since 2010.

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TRUMP DOMINATES TORONTO MONEY SHOW

By Gordon Pape

One theme dominated Friday's opening ceremonies at the Toronto Money Show.

No, it was not the Bank of Canada's latest interest rate hike. Nor was it the Liberal's proposed tax hit to small businesses. It wasn't even Hurricane Irma, although that was top of mind for most of the show's staff, which are based in Sarasota, Florida.

The main focus for most of the speakers was actually U.S. President Donald Trump. Whether they were Canadian or American, almost every speaker seemed fixated on the President and what his policies may or may not achieve for American jobs and economic growth.

Benjamin Tal, deputy chief economist for CIBC World Markets, dismissed Mr. Trump as a blip on the economic landscape.

"The stock market is not up because of him," he told the audience of more than 1,000 people. "He hasn't done anything to change the market…The jobs lost in the U.S. are not coming back and he has no answer to that problem."

Respected American analyst Ed Yardeni agreed. He is the president of Yardeni Research Inc. and his reports are widely used by financial professionals in both Canada and the U.S.

"The way things are going it doesn't look line he'll get much accomplished," he said, speaking on the topic Trump World. "He's his own worst enemy. At times I think he is not even trying."

A counterpoint to those views was delivered by Stephen Moore, a economic advisor to the Trump campaign and currently is the Distinguished Visiting Fellow, Project for Economic Growth, at the Heritage Foundation, based in Washington D.C.

Moore praised Trump's economic plan to a plainly skeptical audience – he asked before starting how many people loved the President and how many hated him and concluded from the response that he had a lot of convincing to do.

He did a credible job of it although a lot will depend on whether Trump can get some key proposals through Congress. The most important of these is tax reform.

The President wants to cut the U.S. corporate tax rate to 15% from the near-40% level (state and federal) right now. It's doubtful he will get it that low, Moore conceded, but 20% seems doable.

"If that happens, the stock market will go way up," he said. "The government will no longer be a 40% stakeholder in a company. That will be cut to 20% and your shares will be worth a lot more."

Tax reform is at the heart of Trump's plan to revive U.S. industry, although Moore conceded the odds of success are no better than 50-50.

What is important, however, is that "Donald Trump has declared the war on business to be over".

EXPECT MORE INTEREST RATE HIKES

Contributing editor Gavin Graham is with us this week with his views on the latest interest rate increase and a look at the banks after the latest quarterly reports. Gavin has had a long and successful career in money management and is a specialist in international securities. He held senior positions in financial organizations in London, Hong Kong, and Toronto. He is a Trustee of Pointbreak, a provider of low-cost specialist ETFs. He divides his time between Toronto and the U.K.

Gavin Graham writes:

Canada's second quarter GDP posted a blowout number of 4.5% annualized growth with the economy displaying

Continued on page 4…

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Interest rate hikes – continued from page 3…

strength on virtually all fronts. These include exports, manufacturing, and even wage growth of 2.7%, the highest since December 2015.

Against that backdrop, it was not surprising to see the Bank of Canada raise its key rate by another quarter-point, to 1%. Another rise in interest rates this fall seems certain. In the process, Bank of Canada Governor Steven Poloz reversed all of the 0.5% reduction he engineered a couple of years ago to offset the weakness in the oil patch. The one sector of the economy that did not show strength was housing, which fell 4.7% in the second quarter, reflecting the slowing market in southern Ontario brought about by government measures. A combination of skyrocketing prices, a shortage of supply, and restrictions on non-resident investors have taken some of the steam out of the formerly booming Toronto market.

But some credit (or blame, depending on your perspective) should be given to the authorities. By reducing the amount that potential house buyers could borrow, raising the rate that is used to calculate affordability by using the posted Bank of Canada rate, and restricting insurance on mortgages over $1 million, the Canadian financial regulators have attempted to be proactive and cool down the rise in house prices before it became too exaggerated.

One group of companies that stands to benefit from a rise in short term rates is the chartered banks. As investors and savers are well aware, the interest rate charged on borrowings always seems to go up faster than that paid on savings. That has the effect of widening the banks' net interest margins (NIM), the major source of the banks' profits.

The three generation lows in short term interest rates over the last few years have been a major handicap to the banks, although given their comfortable oligopoly compared to the much more competitive U.S. market, Canadian banks are still making lots of money. As an example of the difference between the two countries, TD makes almost twice as much in Canada than the U.S. despite actually having more branches (or stores as the bank likes to call them) in the States.

Let's look at the three banks on IWB's recommended list: RBC (TSX, NYSE: RY), TD Bank (TSX, NYSE: TD), and Bank of Nova Scotia (TSX, NYSE: BNS) and see how the last 0.25% increase in Canadian rates and the 0.5% increase in the U.S. have helped over the last two quarters to July 31.

GAVIN GRAHAM'S BANK UPDATES

RBC Group (TSX; NYSE: RY)

Originally recommended on June 7/15 (#21521) at C$79.56, US$63.95. Closed Friday at C$90.53, US$74.53.

Background: RBC is Canada's largest bank and continues to benefit from its market leading positions in mortgage and commercial lending. It also has a strong investment banking performance as well as a rapidly growing asset management business.

Performance: Ironically, as interest rates have risen RBC's stock price has come off 12% from our last review in March. That is partially due to its large U.S. exposure, which has been affected by the strength in the Canadian dollar, which rose by over 8% in the last quarter alone. Despite the retreat, we're still ahead 15% with healthy dividends since recommendation.

Recent developments: RBC reported net income for the third quarter of $2.8 billion, down $99 million (3%) from the previous year. Excluding a $235 million gain on the sale of its home and auto insurance business last year, net income actually rose $136 million (5%).

The results were driven by strength in wealth management, up $98 million (25%). Insurance was up $32 million (25%) and investor and treasury was up $21 million (13%). Personal and commercial banking was up 6% or $77 million to $1.4 billion.

Only capital markets was down by $24 million (4%) to $611 million, on lower volatility and foreign exchange transactions.

The capital equity ratio was 10.9% and provision for credit losses (PCL) remained steady at 0.23% of assets, although the amount was up $18 million (6%).

Dividend: The dividend was raised by $0.04 per quarter (5%) to $0.91, the second increase in this range this year. That gives RBC a yield of just over 4%. Whenever RBC has seen its yield top 4%, apart from the financial crisis of 2008-09, it has proven worth buying. It seems anomalous that the largest and most profitable bank in the country sells at a notably higher yield than its smaller competitors.

Action now: RBC remains a Buy for its strong capital, market leading position, and increasing presence in

Continued on page 5…

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Gavin Graham's bank updates – continued from page 4…

wealth management, as demonstrated by its takeover of U.S. wealth management bank City National in 2016.

TD Bank (TSX, NYSE: TD)

Originally recommended by Tom Slee on Feb. 11/07(#2706) at C$34.98, US$29.80 (split-adjusted). Closed Friday at C$66.13, US$54.47.

Background: TD is Canada's second largest bank, with a large U.S. retail presence, as well as owning 82% of discount broker TD Ameritrade. It has particular strength in retail banking although it also has a strong presence in wholesale banking.

Performance: TD stock has held up much better than RBC over the last few months, despite the sell-off in February on reports of excessive sales pressure on staff. The superior performance perhaps reflected its larger U.S. presence and the benefit of two interest rate increases. It is now trading at more than double the price at which retired contributor Tom Slee recommended it a decade ago. With more than a dozen dividend increases over that period, TD has proven to be a long-term winner for subscribers.

Recent developments: TD almost caught RBC this quarter in terms of absolute income, earning $2.74 billion, up 17%. Earnings at its Canadian retail division were up 14% to $1.73 billion and its U.S. retail side was up 18% (15% in U.S. dollars) to $783 million, excluding TD Ameritrade. With TD Ameritrade included, U.S. retail income was still up 14% (11% in U.S. dollars) to $901 million, while wholesale earnings were steady at $293 million.

"This was a great quarter for TD reflecting impressive earnings and revenue growth, improved credit performance across all our businesses, and lower insurance claims" said CEO Bharat Masrani.

The capital equity ratio rose 0.2% to 11%, maintaining TD's strong capital position.

Dividend: There was no change. The payment remains at $0.60 a quarter, after the 9% increase in March, giving TD a yield of 3.6%.

Action now: TD remains a Buy for its growing U.S. presence, strength in Canadian retail, and professional management.

Bank of Nova Scotia (TSX: NYSE: BNS)

Originally recommended by Tom Slee on Jan. 16/11 (#21102) at C$56.83, US$57.34. Closed Friday at C$76.13 US$62.70.

Background: Scotiabank is the most international of Canada's Big Six chartered banks, with over 40% of its earnings derived from its extensive Latin American and Asian operations. It is the sixth largest bank in Mexico and the third largest in Peru. It has a reputation for having the lowest expense ratio of any of the banks.

Performance: Scotiabank has also held up relatively well over the last few months. The shares are down slightly from the last review but up 40% over the last six years with a number of dividend increases since Tom Slee recommended it.

Recent developments: Scotia delivered earnings of $2.1 billion for the third quarter, up 7% or $144 million. Canadian personal and commercial banking earnings exceeded $1.04 billion, up 12%, while international banking earnings rose 16% to $614 million. Meanwhile, global (wholesale) banking rose 5% to $441 million.

The PCL fell 0.02% to 0.45%, reflecting the higher credit losses in its Latin American business. The capital equity ratio was unchanged at 11.3%.

Scotiabank recently announced it has acquired the naming rights to the Air Canada Centre, the home of the Toronto Maple Leafs and Raptors, for $800 million. The contract is for 20 years, starting next summer. For those worried that Scotia's management has abandoned its cost-conscious approach, a good analysis in The Globe and Mail noted that this averaged out at $40 million a year, with the initial years actually costing less than that.

Furthermore, this is part of Scotia's focus on the NHL, where it is already the official bank for the league and all seven of Canada's NHL teams. The bank is cutting back on other sponsorships, such as the CFL, and cultural activities such as Nuite Blanche in Toronto.

Finally, Scotia announced last week that it was in non-binding talks to purchase BBVA Chile, the subsidiary of major Spanish bank BBVA. With equity of over US$1 billion, BBVA Chile would be a sizeable acquisition. It is in one of the four Pacific Alliance Latin American countries that Scotia has focused on in the last five years, the others being Mexico, Colombia, and Peru,

Dividend: Scotiabank raised its dividend by $0.03 to $0.79 a quarter, the fourth increase in eighteen months. That gives it a yield of 4.1%.

Action now: Scotia remains a Buy for its extensive international exposure to the less banked and faster growing Latin American and Asian economies, its strict cost controls, and its growing wealth management division.

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GORDON PAPE'S UPDATES

Wells Fargo & Company (NYSE: WFC)

Originally recommended on Jan. 27/13 (#21304) at $35.14. Closed Friday at $49.58. (All figures in U.S. dollars.)

Background: Wells Fargo is a diversified financial services company with $1.9 trillion in assets. Founded in 1852 and headquartered in San Francisco, Wells Fargo serves one in three households in the U.S., providing services in banking, insurance, investments, mortgage, and consumer and commercial finance. It has more than 8,500 locations, 13,000 ATMs, and Internet and mobile banking. The bank has offices in 42 countries and territories and employs approximately 271,000 people. Wells Fargo was ranked No. 25 on Fortune's 2017 rankings of America's largest corporations.

Performance: The stock has dropped more than $4 from the time of our last review in July, falling below its 50- and 200-day moving averages.

Recent developments: Just when we thought the scandal of the falsified accounts was behind us, there are stunning new revelations that show that what we saw previously was just the tip of the iceberg.

On Aug. 31, the company announced the results of a third-party review into fraudulent personal and small business accounts covering the period from January 2009 to September 2016. The study concluded that Wells Fargo employees had opened a staggering 3.5 million unauthorized accounts in an effort to meet sales quotas. The original figure quoted by the bank was 2.1 million, although that covered a shorter time period, from May 2011 to mid-2015. The new numbers indicate how deeply the culture of fraud ran in the organization.

In July, Wells Fargo reached a class-action settlement with its customers worth $142 million. It has received preliminary approval from a judge but that may now be revoked in the light of the latest numbers. If that happens, the financial penalties levied against the company could soar.

CEO Tim Sloan, who was appointed to the top post after his predecessor was forced to resign, was appropriately humble.

"We apologize to everyone who was harmed by unacceptable sales practices that occurred in our retail bank," he said. "To rebuild trust and to build a better Wells Fargo, our first priority is to make things right for our customers, and the completion of this expanded third-party analysis is an important milestone. Through this expanded review, as well as the class action settlement, free mediation services, and ongoing outreach and complaint resolution, we've cast a wide net to reach customers and address their remaining concerns. Our commitment has never been stronger to build a better bank for our customers, team members, shareholders and communities."

But his apologies are nowhere good enough for the battery of lawyers representing clients. They are busy preparing new submissions urging the courts to reopen the case in force the company into substantially increasing its settlement offer.

Customers and investors have been voting with their money. Wells Fargo has lost its title as the world's most valuable bank and its assets under management have dropped below $2 trillion. The stock is down from a high of about $60 in March and closed Friday at $49.58.

Dividend: About the only good news for investors is that the company increased its quarterly dividend by a penny to $0.39 per share ($1.56 per year) effective with the August payment. At this lower price, the yield is up to 3.1%.

Action now: Hold. The bank will eventually recover – it's too big to fail. But the stench of this scandal will linger for some time and the final cost of settling with wronged clients will probably end up being tens of millions of dollars more. If you are in the market for a U.S. banking stock, avoid this one for now. JPMorgan Chase (NYSE: JPM) is a better choice.

TransCanada Corp. (TSX, NYSE: TRP)

Originally recommended by Yola Edwards on April 23/06 (#2616) at C$34.07, US$29.92. Closed Friday at C$62.09, US$51.15.

Background: TransCanada operates a network of natural gas pipelines that extends more than 68,000 kilometres, tapping into virtually all the major gas supply basins in North America. It is also active in power generation with a 31.6% stake in the Bruce Power nuclear plant in Ontario.

Performance: The share price is virtually unchanged since our last update in May. Over the past year, the shares have traded in a narrow range between $58 and $64.

Continued on page 5…

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Gordon Pape's updates – continued from page 4…

Recent developments: The company reported strong second-quarter results on July 28. Revenue for the period was $3.2 billion, and increase of almost 17% from just under $2.8 billion a year ago. For the first half, revenue was $6.6 billion, up almost 26% from $5.3 billion in 2016.

Net income attributable to common shares was $881 million ($1.01 per share, fully diluted). That compares with $365 million ($0.52 per share) a year ago. For the first half, net income was $1.5 billion ($1.75 per share), compared to $617 million ($0.88 per share) in 2016.

"Comparable earnings per share increased 46% compared to second quarter 2016 primarily due to the Columbia acquisition in July 2016 and the realization of associated synergies, strong performance across our Natural Gas and Liquids Pipelines businesses, and higher earnings from Bruce Power following a major planned outage in second quarter 2016," said CEO Russ Girling. "The growth in earnings was accompanied by a significant increase in net cash provided by operations which rose to $1.4 billion from $1.1 billion in the same period last year."

Meantime, discussions about the future of the Keystone XL pipeline grind on. In July, the company started soliciting companies to commitments to use the cross-border line, if it is ever built. TransCanada is reportedly looking for contracts to ship an additional 225,000 barrels per day, over and above current commitments. The pipeline is designed to carry 830,000 barrels a day from Canada to the Gulf Coast. The search for commitments was supposed to run until late September but has now been extended for a month – not a good sign.

At the political level, the project is being reviewed by the Nebraska Public Service Commission, which has the final say on a go-ahead. There is strong opposition within the state but the Governor recently said he expects Keystone will eventually be approved. The Commission is due to report by the end of November.

Dividend: The stock pays a quarterly dividend of $0.625 per share ($2.50 per year) for a yield of 4%. Management is targeting annual dividend increases of between 8% and 10% at least through 2020.

Action now: Buy for income. The share price is in a holding pattern right now but the yield is attractive and safe.

Amazon.com (NDQ: AMZN)

Originally recommended on Jan. 16/17 (#21703) at $817.14. Closed Friday at $965.90. (All figures in U.S. dollars.)

Background: Amazon is one of the world's largest retailers, but it is also involved in a range of other businesses, such as cloud storage, movies, and video streaming.

Performance: The shares briefly cracked through the $1,000 level in July but have since retreated to the current price. Despite the pullback the stock is up 18% from the time of our original recommendation in January.

Recent developments: Amazon announced an impressive 25% increase in second-quarter net sales to $38 billion, up from $30.4 billion in the same quarter of 2016. That was slightly above analysts' estimates. However, net income disappointed. The company earned $197 million in the quarter ($0.40 per share, fully diluted). That compared to $857 million ($1.78 per share) last year. The profit was down due to heavy investment in growth areas like video content for its Amazon Prime streaming service.

"In the last few months, we launched Echo Show (our newest Echo device with a video screen), introduced calling and messaging via Alexa on all Echo devices, debuted Inside Edge on Prime Video (the first of 18 Indian Original Series), introduced Amazon Channels in both the U.K. and Germany, launched four new Fire tablets, expanded Amazon Fresh to Germany, launched Prime Now in Singapore, launched our 25th airplane with Prime Air, hired more than 30,000 new employees, opened three new Amazon Books stores, launched more than 400 significant AWS features and services, migrated more than 7,000 databases using AWS Database Migration Service, and held our third annual Prime Day — signing up more Prime members than ever before," said founder and CEO Jeff Bezos, in a sentence that must have left him breathless.

"It's energizing to invent on behalf of customers, and we continue to see many high-quality opportunities to invest."

Bezos may be thrilled but investors have turned a little cool lately. Most would like to see a greater portion of the booming sales flow through to the bottom line.

The purchase of Whole Foods was completed in August and Amazon immediately moved to reduce prices on a wide range of items in the U.S. and Canada. Stocks in grocery companies plunged in response although there is no evidence yet that Amazon is poised to grab a larger market share. However, investors remember what the company did to booksellers like Barnes & Noble and reacted accordingly.

Dividend: The stock doesn't pay one and is not expected to do so any time soon.

Action now: Buy. The price retreat offers an entry opportunity. Profits may be temporarily down but the future potential is huge. But keep in mind that the stock has a volatile history. If you can't handle that, look elsewhere.

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